Basic Principles | Measuring Business Momentum

Transcript

August 2023

Duilio R. Ramallo, CFA
Senior Portfolio Manager

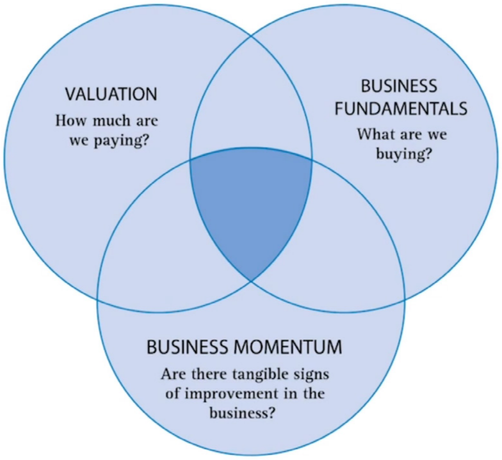
Boston Partners uses three attributes to guide the bottoms-up investment process: attractive valuation, strong fundamentals, and good business momentum.

In the latest installment of Basic Principles, Duilio Ramallo, Senior Portfolio Manager, discusses the importance of positive momentum when evaluating a business, as well as the differences between fundamental momentum and catalyst driven momentum.

Duilio Ramallo, Senior Portfolio Manager at Boston Partners

Is the business getting better or is it getting worse? At Boston Partners, this is one of the questions at the heart of our investment approach. I'm Diulio Romallo, senior portfolio manager at Boston Partners. At Boston Partners we think it's essential to understand the drivers that make every business work. That is business momentum.

Our investment process at Boston Partners is a bottom-up investment process that's centered around finding and identifying stocks that have the three attributes: attractive valuations, strong fundamentals and good business momentum - referred to as the three circles. It's partly done qualitatively and partly done quantitatively. Simply said, a portfolio that has all three characteristics tilts the probabilities of success in our favor.



Two Categories of Momemtum: Our Approach at Boston Partners

- FUNDAMENTAL MOMENTUM
  Answering basic questions about the company

- CATALYST-DRIVEN MOMENTUM
  Discrete events or developments in the business

When we think about momentum, we think about it in two broad categories: fundamental momentum and catalysts driven momentum. Fundamental momentum seeks to answer the question – are sales improving, are marginal rates of return getting better, are earnings getting better or growing. Catalyst business momentum deals with discrete items – a management change, an acquisition, a divestiture. Ultimately, you always want catalyst-driven momentum to lead to fundamental driven momentum. It's really earnings, cash flow, sales growth that we're interested in as investment managers.

As a value manager, we use momentum as a timing tool – when to buy stocks and when to exit stocks, and avoiding value traps, stocks that have attractive valuation characteristics but negative momentum tend to underperform.

Momentum can be understood as an absolute measure. Are sales are growing, are earnings improving, are marginal rates of return on investment improving? But momentum is best understood as a relative gain, relative to expectations, relative to the peer group and relative to performance. Expectations for company performance are guided by company management, and it's typically the bars that Wall Street analysts set that guide expectations for performance. Companies that are beating expectations tend to drive stock outperformance. Companies that are missing expectations tend to underperform.

Let me give you an example. Two companies, Company A is expected to grow 10% grows at 8%. Company B is expected to grow at 5% and grows at 7%. 8% is still better than 7% on an absolute basis. The company that was expected to grow at ten but is now growing at eight has negative momentum on a relative basis. And the company that was expected to grow at five and is now growing at seven has positive momentum on a relative basis. So while on an absolute basis you would always select the company that has the better growth relative to the company that has lower growth. In the momentum world, we think about things on a relative

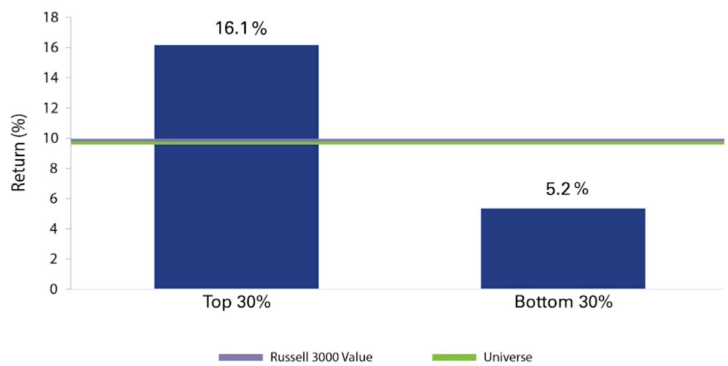
Hypothetical Companies: Expectations vs. Actual Returns

Data as of June 30, 2023. Source: Boston Partners.
Past performance is not an indication of future results. Please refer to the end of the document for other important disclosures.

basis and relative to expectations that company that has the better absolute growth will typically underperform on a stock performance basis than the company that is growing at an absolute lower level but has positive momentum. Again, you could have an environment where the stock market is down, but some companies are going to be down 2% and other companies will be down 30% in stock price. We're seeking to capture the relative performance of companies, not the absolute performance of companies.

The momentum factor is important primarily because it works. If you look at our quantitative models going back since 1990, you can see that the top 30% of companies with positive business momentum outperformed the market by on average 600 basis points on an annualized basis. And the companies in the bottom 30% of investment momentum underperformed the market by 400 basis points. The performance differential between the top 30% of momentum and the bottom 30% in momentum is over 1,000 basis points of performance, a significant amount, which is why momentum is very important to consider.

Boston Partners U.S. All Cap Momentum Model Average Annual Return (June 1990-2023)



Data as of June 30, 2023. Source: Boston Partners.
Past performance is not an indication of future results. Please refer to the end of the document for other important disclosures.

Using earnings revisions as a proxy for business momentum. Let's look at two companies, one with positive business momentum and one with negative business momentum. Here we have the earnings revisions for Alphabet or Google over a five-year period, earnings revisions trended higher from 2020 to 2022. And the stock performance follows very closely with earnings revisions heading higher. When earnings momentum turned negative for Google beginning in 2022, you can see the stock price trails off. But in general, over this period of time, earnings are higher rather than lower. Companies that have positive momentum tend to continue to have positive momentum. In contrast, let's look at IBM, the company that has negative earnings momentum. The

Alphabet Inc. Price and Bloomberg Best Estimate

Data as of August 21, 2023. Source: Boston Partners.
Past performance is not an indication of future results. Please refer to the end of the document for other important disclosures.

estimates for IBM tend to trend negative over this entire period, and the stock price tends to tread water over this entire period. And if you look at the relative performance of both stocks over this time period compared to the S&P 500, you can see that Google outperforms the market and IBM underperforms the market, considerable spread between the two and a considerable performance difference between the two.

IBM
Price and Bloomberg Best Estimate

Relative Strength vs. S&P 500

Data as of August 21, 2023. Source: Boston Partners.
Past performance is not an indication of future results. Please refer to the end of the document for other important disclosures.

At Boston Partners, we feel that momentum is an important tool to consider. It drives investment performance, helps us avoid the value trap, acts as the timing tool for stock selection. On the surface, it sounds simple, but there's a lot of nuance to consider, and we believe that momentum plays an important factor in portfolio construction, coupled with fundamentals and valuation that tilts the probabilities of success of outperformance in our favor.

Duilio R. Ramallo, CFA | *Senior Portfolio Manager*

Mr. Ramallo is the senior portfolio manager for the Boston Partners Premium Equity product. Previously, Mr. Ramallo was the assistant portfolio manager for the Small Cap Value products. Prior to his portfolio management role, Mr. Ramallo was a research analyst for Boston Partners. He joined the firm in December 1995 from Deloitte & Touche L.L.P., where he spent three years, most recently in their Los Angeles office. Mr. Ramallo holds a B.A. degree in economics/business from the University of California at Los Angeles and an M.B.A. from the Anderson Graduate School of Management at UCLA. He holds the Chartered Financial Analyst® designation. He is also a Certified Public Accountant (inactive). Mr. Ramallo began his career in the investment industry in 1995.

Disclosure

Boston Partners Global Investors, Inc. ("Boston Partners") is an Investment Adviser registered with the Securities and Exchange Commission under the Investment Advisers Act of 1940. Registration does not imply a certain level of skill or training. Boston Partners is an indirect, wholly owned subsidiary of ORIX Corporation of Japan ("ORIX"). Boston Partners is comprised of two divisions, Boston Partners and Weiss, Peck & Greer Partners ("WPG").

This video is not an offering of securities nor is it intended to provide investment advice. It is intended for information purposes only.

References to specific holdings are presented to illustrate our investment philosophy and are not to be considered recommendations. The specific securities identified and described do not represent all of the securities purchased, sold or recommended for advisory clients. It should not be assumed that an investment in these securities was or will be profitable.

Index Definitions

Index returns are provided for comparison purposes only to show how the composite's returns compare to a broad-based index of securities, as the indices do not have costs, fees, or other expenses associated with their performance. In addition, securities held in indices may not be similar to securities held in the composite's accounts.

The S&P 500® Index is an unmanaged index of the common stocks of 500 widely held U.S. companies.

Net total return indexes reinvest dividends after the deduction of withholding taxes, using (for international indexes) a tax rate applicable to non-resident institutional investors who do not benefit from double taxation treaties.

Russell 3000® Value Index measures the performance of those Russell 3000® Index companies with lower price-to-book ratios and lower forecasted growth values. The stocks in this index are also members of either the Russell 1000® Value or the Russell 2000® Value Indices.